Finding the Pot of Gold at the End of the Family Limited Partnership Rainbow

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All Entities are Not Created Equal

One of the least discussed and reasoned decisions in entity planning for discount purposes is whether to use a limited liability company (LLC) format or that of the family limited partnership (FLP). On the surface, as an LLC is taxed as a partnership under the Internal Revenue Code,[1] practitioners often conclude that there should be no difference.

This may not be correct. The decision to the practitioner is not one of merely preference, but requires consideration of several important tax issues prior to selecting the optimal structure. This article discusses three of those issues: first, the appearance of the entity, including its name, to the Service from a tax perspective; second, the potential application of Code Sec. 2704 (b) of chapter 14, a section that has been quiet judicially since B.P. Kerr[2] in 2002, but which continues to require attention; and, finally, how LLCs interests may be subject to the passive activity loss (PAL) rules in a more lenient way than FLP interests.

What's in a Name?: FLP vs. LLC

One well-known structuring element for FLPs is the strength of the name. For example, an entity known as the "Jones Family Limited Partnership" connotes an intra-family strategy that may have at its heart a desire to invest family marketable assets for estate planning discounting purposes. The connotation arises because the phrase "Family Limited Partnership" has now become synonymous with marketable asset discount planning.

As practitioners, we want to distance partnerships from this connotation. If the above named "Jones Family Limited Partnership" is investing 25 percent of its assets in an operating manufacturing concern and another 30 percent in commercial real estate investments, a more appropriate name could be "JF Private Equity Ventures, LP," as the investments are primarily of a private equity nature.

What difference does it make? While either name may aptly capture the essence of the entity, we would argue that the "Jones Family Limited Partnership" is more likely to receive Service attention than "JP Private Equity Ventures, LP."

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[1] Pursuant to the check-the-box Regulations, unincorporated eligible entities with two or more owners (i.e., most entities, other than corporations, estates, and trusts) are treated as partnerships for Federal tax purposes. Reg. §§ 301.7701-1 through -4, and -7, This would include a general partnership, a limited partnership, limited liability partnership, or limited liability limited partnership.

[2] *B.P. Kerr*, 113 TC __, No. 30, 113 TC 450, Dec. 53, 667 (1999), *Aff'd*, CA-5, 2002-1 USTC ¶ 60,440, 292 F3d 490 (2002).

While a well-chosen FLP name may distance the entity from the discount planning connotation, perhaps an even more effective distancing can be achieved by using a LLC in lieu of a FLP. Abuses and controversies in discount planning have typically involved FLPs. With the widespread use of LLCs for a multitude of new operating businesses, an LLC used for discount planning may well receive less Service attention. Thus, at least in the short-term, arguably "JF Private Equity Ventures, LLC" is a better choice than even "JF Private Equity Ventures, LP."[3]

<u>Code Sec. 2704 (b): All's Quiet on the Western Front</u>

For a partnership to work for discount planning, the interests being valued typically carry with them no right of control, ability to liquidate, or ability to mandate a cash distribution, the typical lack of rights associated with limited partnership interests. Importantly, the lack of rights must be mandated by state law, not created by the parties.

Code Sec. 2704 (b) provides that an "applicable restriction," one created by the parties, will not be respected at death if that restriction occurs in a family-control setting. The argument has been successfully made that a term partnership (where state law mandates a perpetual partnership in the absence of a shorter term) results in an inability to liquidate by the limited partners under state law, and therefore it is not an applicable restriction. The term partnership has been approved by the Tax Court as a means to avoid Section 2704(b).[4] It is entitled to a discount because the default rule under most Revised Limited Partnership Acts is that a limited partner has no right to withdraw for fair value unless the document provides that right. Further, the limited partner by statute has no right to control the partnership or force a dissolution (e.g., a dissolution would in effect cause the limited partner to be able to liquidate the limited partner's interest). Hence, the limited partnership interest is not desirable to many buyers, and would be entitled to an illiquidity discount (due to a lack of buyers who want that interest)

As a specific example, under Section 603 of the Illinois Uniform Limited Partnership Act, a limited partner, absent an express provision in the agreement to the contrary, may not withdraw and obtain his or her fair value, or assign his or her interest, prior to dissolution or the expiration of the term:

> ***Section 603.*** <u>*Withdrawal of Limited Partner.*</u> *A limited partner may withdraw from a limited partnership only at the time or upon the happening of events specified in writing in the partnership agreement and in accordance with the partnership agreement. Notwithstanding anything to the contrary under applicable law, unless a partnership agreement provides otherwise, a limited partner may not withdraw from a limited partnership prior to the dissolution and winding up of the limited partnership.*

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[3] To the extent that LLCs would become more commonly used for discount planning, Service attention would likely heighten thereby diminishing the value in the long-run of an entity name with "LLC."

[4] *See, e.g., Kerr*, 113 TC 449 (1999).

> *Notwithstanding anything to the contrary under applicable law, a partnership agreement may provide that a partnership interest may not be assigned prior to the dissolution and winding up of the limited partnership.*

In *Kerr*, the court concluded that the "term" nature of the partnership formed under Texas law did not constitute an applicable restriction under Code Sec. 2704(b):

> *"We reached this conclusion because Texas law provides for the dissolution and liquidation of a limited partnership pursuant to the occurrence of events specified in the partnership agreement whereupon the written consent of all partners, and the restrictions contained in Section 10.01 of the partnership agreements are no more restrictive than the limitations that generally would apply to the partnerships under Texas law."* [5]

Similar results were reached in Harper v. Comm'r[6] and Jones II.[7]

In the LLC setting, typically any member can participate in the management of the LLC, in forcing a dissolution, or in electing a manager whose ability it is to determine distributions. All of these rights could effect, or even eliminate, the discount. Therefore, for an LLC to work for discounting purposes, the members should have no unilateral right to control the manager, should not be able to become a manager (except a "limited manager" as discussed below), and the state law governing the LLC should provide for a perpetual LLC absent an agreement by the members to the contrary.

If Code Sec. 2704(b) can be avoided in the LLC setting, than the LLC should be as effective as an FLP for discount purposes. But the practitioner should focus on the 2704(b) issue when using LLCs versus FLPs.

PALs are not Our PALS when we Use Entities for Discount Planning

Income tax ramifications also impact the choice between a FLP and LLC. Superficially, since members of LLCs are normally treated as partners for Federal income tax purposes, it would seem that these two entities are equivalent for income tax purposes, but two recent cases dealing with the application of the PAL rules indicate they are not. Let's first examine the impact of PALs on FLPs.

Though the structure of the FLP may be geared towards the estate tax side, income tax considerations cannot be ignored. For example, it is important to recognize that if losses incurred by a FLP are passive, they get moved to a suspense account and are

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[5] Id., at

[6] T.C. Memo 2000-202 (1999)

[7] 116 T.C. No. 11 (2001).

useable only against passive income, or when the asset is sold. The danger, here, is that the FLP may be held until death, and is often structured as such.[8]

At death, the basis is adjusted[9] for income tax purposes to fair market value (FMV) under Code Sec. 1014(a), often referred to as "step-up" or "step-down" basis. A transfer of a taxpayer's interest in a passive activity by virtue of the taxpayer's death results in suspended PALs being allowed (generally on the final return of the deceased taxpayer) but only to the extent they exceed the amount, if any, of the step-up in basis allowed.[10] Accordingly, the passive losses that have accumulated may not be deductible.

For example, suppose a taxpayer dies with a passive activity in which they have an adjusted basis of $400,000, suspended PALs of $250,000, and a "discounted" fair market value (FMV) at the decedent's date of death of $750,000. The step-up in basis would be $350,000 ($750,000 date-of-death FMV - $400,000 adjusted basis). Because the $250,000 of suspended PALs does not exceed the step-up basis amount, $350,000, none of the losses are deductible by the decedent (or, for that matter, any beneficiary). The suspended PALs "evaporate," thus producing no Federal income tax savings.

Thus, avoiding application of the PAL rules is an important planning consideration. However, as a limited partner in a FLP, that will be difficult to do. With FLPs, actual participation by the limited partners would be contrary to the goals of not having any control or management functions related to the limited partnership interest. As such, the limited partner(s) would not likely meet any of the three tests applicable to a limited partner necessary to establish material participation.[11] As a passive activity, the FLP's otherwise ordinary businesses losses would be treated as passive, and thereby lost in the short-term and, potentially, forever.

How do the PAL rules impact LLC interests? The key issue is whether a member of a LLC should be treated as a general partner or a limited partner. The distinction is important because, under Code Sec. 469, it is easier for a general partner than a limited partner to materially participate in an activity. Code Sec. 469(h)(1) provides that a taxpayer materially participates in an activity if the taxpayer is involved in the operation of the activity on a basis that is regular, continuous, and substantial. [12] However, Code

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[8] Even if not held until death, to the extent that the PALs are suspended and first deductible in the future, the present value of the tax savings associated with the PAL reduces each year that the deduction is carried forward to the future.

[9] The estate tax laws in 2010 are bizarre and are, accordingly, best viewed as a one year aberration. Accordingly, this article assumes the law pre-2010 will be the laws then in effect.

[1010] Code Sec. 469(g)(2).

[11] These are Tests 1, 5, or 6 identified in note 12, *infra*.

[12] Under Temp. Reg. Sec. 1.469-5T(a), seven tests were established for assessing whether an individual materially participates in an activity. A taxpayer can meet any one of these tests to be considered materially participating. The tests are:

1. Does the individual participate in the activity for more than 500 hours during the year?
2. Does the individual's participation in the activity for the taxable year constitute substantially all of the participation in the activity of all individuals for the year?

Sec. 469(h)(2) provides that "[e]xcept as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates."

While a general partner may qualify as materially participating by meeting any of seven tests,[13] a limited partner generally is not considered materially participating unless he or she meets one of only three tests. Pragmatically, absent material participation in the activity in prior years, a taxpayer who participates for less than 500 hours in the tax year in an activity in which the taxpayer is a limited partner generally cannot be viewed as materially participating; in some situations, a general partner in these circumstances could still be deemed to materially participate.

In two recent cases, the Service argued unsuccessfully that members of a LLC should be treated as limited partners for purposes of the PAL rules. In *P.D. Garnett*,[14] the U.S. Tax Court held that members of a LLC are general partners for determining whether they materially participated in the LLC under the temporary Code Sec. 469 regulations. In *J.R. Thompson*,[15] the U.S. Court of Federal Claims reached a similar holding.[16] Based on these two cases, members of a LLC are afforded greater opportunities – seven tests – than are available to limited partners – only three tests – for establishing that they have materially participated in the business of the LLC.

A desired structuring of discount planning is to mix marketable assets and businesses to provide the best non-tax justification and "feel" for the entity to be respected. For example, suppose that a family business entity is established via a contribution of 75 percent marketable assets and 25 percent operating business. Assume that the 25 percent comprised of the operating business throws off both taxable income and potentially taxable losses.

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3. Does the individual participate in the activity for more than 100 hours during the year, and is the individual's participation in the activity for the year not less than the participation of any other individual for the year?
4. Is the activity a significant participation activity for the taxable year, and does the individual's aggregate participation in all significant participation activities during the year exceed 500 hours?
5. Did the individual materially participate in the activity for any 5 taxable years during the 10 taxable years that immediately precede the taxable year?
6. Is the activity a personal service activity, and did the individual materially participate in the activity for any three preceding taxable years?
7. Based on all of the facts and circumstances, did the individual participate in the activity on a regular, continuous, and substantial basis during the year?

[13] Id.

[14] 132 TC No. 19.

[15] 104 AFTR 2d 2009-5381 (Fed. Cl. Ct., 2009).

[16] The *Thompson* court specifically adopted a rule that the passive loss rules under 469 are to apply in the partnership setting, but not necessarily in the LLC setting. Under the court's reasoning, it is not the limited liability that is the key feature to the passive loss rules, but rather the management function. If the partner has management control, then this is tantamount to participation, and eliminates the passive loss concerns under section 269: "Finally and most importantly, an LLC is not 'substantively equivalent' to a limited partnership…LLCs are designed to permit active involvement."

Traditionally, the majority of the equity in a FLP is represented by limited partnership interests; e.g., 95 percent of the equity being limited partnership interests would be a structure that is used. If losses are thrown off by the operating business (i.e., 25 percent of the FLP), those losses are usually allocated 95 % to the limited partners.

If the losses are useable, they will offset the partner's ordinary income, a good result. If the losses are passive, they get moved to a suspense account and, as demonstrated above, may never be useable.

The question is whether in an LLC used for discount planning purposes the members can meet the lowest threshold (i.e., Test 3) test to avoid PAL treatment. Though delicate in structuring, the LLC should afford this opportunity. In an LLC, a member may still be able to participate as a manager, while not having full control of liquidation and distribution decisions. In other words, it would be possible to structure the LLC so that there are two managers, a decision manager, whose purpose it is to determine if there are distributions, sales, mergers, dissolution and liquidations; and an administrative manager, whose purpose it would be to determine and manage the investments. The administrative manager should be able to hold on to LLC interests without jeopardizing the discounts inherent in those interests. Further, using the more lenient PAL tests for general partners (and, thus, based on *Garnett* and *Thompson*, LLC membership interests), the operating losses from the LLC may avoid the PAL limitations, an interesting gambit.

Conclusion

Due to the discount planning connotation associated with the phrase, "Family Limited Partnership," a LLC format may be a better choice than a FLP as a basis for avoiding IRS scrutiny. Moreover, because of *Garnett* and *Thompson*, practitioners may now want to consider using the LLC format for discount planning when that entity will be comprised in part of an operating business, in order to get around the PAL rules.